

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-0309
Indiana Corporate Income Tax
For the Tax Years 1998, 1999, and 2000

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ISSUES

I. Money Received by Taxpayer While Acting in an Agency Capacity – Gross Income Tax.

Authority: IC 6-2.1-2-2(a)(1); IC 6-2.1-2-2(a)(2); Policy Management Systems Corp. v. Indiana Department of State Revenue, 720 N.E.2d 20 (Ind. Tax Ct. 1999); Universal Group Limited v. Indiana Department of State Revenue, 642 N.E.2d 553 (Ind. Tax Ct. 1994); 45 IAC 1.1-1-2; 45 IAC 1.1-6-10.

Taxpayer argues that certain money it received was actually received on behalf of its customers. Because taxpayer was acting as an agent for the customers, taxpayer maintains that the money received on behalf of these customers was not subject to gross income tax.

II. Money Received from the Sale of Inventory Stored at Customer Locations – Gross Income Tax.

Authority: IC 6-2.1-2-2; IC 6-2.1-2-3; IC 6-2.1-2-4.

Taxpayer argues that the income received from the sale of inventory items sold at various Indiana customer locations was not subject to gross income tax.

III. Business / Non-business Classification – Adjusted Gross Income Tax.

Authority: IC 6-3-1-20; IC 6-3-1-21; IC 6-3-2-2(b); IC 6-3-2-2(g) to (k); May Department Store Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001); 45 IAC 3.1-1-29; 45 IAC 3.1-1-30; I.R.C. § 338(h)(10).

Taxpayer maintains that the audit erred in reclassifying certain income as “business income.” Specifically, taxpayer states that interest received on short term-deposits, rent from the lease of unused corporate property, license fee royalties, and money received from the “deemed sale of [stock] assets” should be classified as “non-business” income.

STATEMENT OF FACTS

Taxpayer was an out-of-state entity in the business of developing and supplying coatings to the electro-plating, electronics, and surface finishing industries. Taxpayer had Indiana employees which solicited business on taxpayer's behalf.

The Department of Revenue (Department) conducted an audit of taxpayer's federal returns, state income tax work-papers, and various other business records. The audit resulted in a determination that taxpayer owed additional Indiana corporate income tax. Taxpayer disagreed with the audit's decision and submitted a protest to that effect. An administrative hearing was held during which taxpayer was provided an opportunity to explain the basis for its protest; this Letter of Findings results.

DISCUSSION

I. Money Received by Taxpayer While Acting in an Agency Capacity – Gross Income Tax.

After performing "chemical management services" for Indiana customers, taxpayer was reimbursed for expenses it incurred on behalf of those customers. The audit determined that these reimbursed expenses were part of taxpayer's gross income and taxed the income at the state's high rate gross income tax.

Taxpayer maintains that the reimbursed expenses are not true income but reflected loans made to its customers. Therefore, when the customer paid back these loans to taxpayer, it was simply receiving the money in an agency capacity.

Indiana imposes a gross income tax upon the entire gross receipts of a taxpayer who is a resident or domiciliary of Indiana. IC 6-2.1-2-2(a)(1). For the taxpayer who is not a resident or domiciliary of Indiana – such as taxpayer – the tax is imposed on the gross receipts which are derived from business activities conducted within the state. IC 6-2.1-2-2(a)(2). However 45 IAC 1.1-6-10 exempts that portion of the taxpayer's income which the taxpayer receives when acting in an agency capacity. 45 IAC 1.1-1-2 defines an "agent" as follows:

(a) "Agent" means a person or entity authorized by another to transact business on its behalf.

(b) A taxpayer will qualify as an agent if it meets both of the following requirements:

(1) The taxpayer must be under the control of another. An agency relationship is not established unless the taxpayer is under the control of another in transacting business on its behalf. The relationship must be intended by both parties and may be established by contract or implied from the conduct of the parties. The representation of one (1) party that it is the agent of another party without the manifestation of consent and control by the alleged principal is insufficient to establish an agency relationship.

(2) The taxpayer must not have any right, title, or interest in the money or property received from the transaction. The income must pass through actually or substantively, to the principal or a third party, with the taxpayer being merely a conduit through which the funds pass between a third party and the principal.

The Indiana Tax Court in Policy Management Systems Corp. v. Indiana Department of State Revenue, 720 N.E.2d 20 (Ind. Tax Ct. 1999) and Universal Group Limited v. Indiana Department of State Revenue, 642 N.E.2d 553 (Ind. Tax Ct. 1994) reviewed the relationship between imposition of the state's gross income tax and agency principles, echoed the standards set out in 45 IAC 1.1-1-2 and 45 IAC 1.1-6-10, and held that an agency relationship required consent by the principal, acceptance and authority by the agent, and control of the agent by the principal.

Assuming that a true agent/principal relationship is established, the agent will not be responsible for paying gross income tax on money it receives on behalf of the principal. The agent has no gross income tax liability because it never actually controls the money. The agent is simply collecting the money on behalf of the principal and passes that identical amount over to the principal. The agent never has any possessory right to the money because the agent is always acting on behalf of the principal and at all times, the money belongs to the principal; the agent is merely a financially disinterested intermediary between the payor and the principal.

Taxpayer was not acting as an agent when it was reimbursed for expenses incurred initially on behalf of its customers. There simply is no agent/principal relationship here. The taxpayer was not "passing along" this money to anyone. Taxpayer may have incurred these expenses on behalf of and for the convenience of its customers and it may have simply been reimbursed on a dollar-for-dollar basis, but there is no agent/principal relationship between any of the parties involved in these transactions.

In addition, there is a total absence of the hallmarks that would signal taxpayer is acting as another entity's agent. There is no indication taxpayer is under the control of another entity; there is no indication that taxpayer did not ultimately have control of the reimbursed expenses. For taxpayer, the reimbursement of the expenses incurred on behalf of the customers may have been no-gain/no-loss transactions. However, taxpayer mistakes financially transparent exchanges for transactions in which it receives money while acting in a true agency capacity.

FINDING

Taxpayer's protest is respectfully denied.

II. Money Received from the Sale of Inventory Stored at Customer Locations – Gross Income Tax.

The audit adjusted taxpayer's gross income tax in order to reflect receipts obtained from the sale of inventory stored at customer locations. Taxpayer's argument is that it "disagrees with the adjustment."

Taxpayer stored inventories of goods at customer locations within Indiana. At various times during 1998, 1999, and 2000, taxpayer sold those goods to the customer.

Indiana's gross income tax "is imposed upon the receipt of: (1) the entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana; and (2) the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana." IC 6-2.1-2-2.

A taxpayer's gross receipts are subject to either the "high rate" (1.2 percent) or the "low rate (0.3 percent). IC 6-2.1-2-3. The audit determined that the sale of inventoried goods to the Indiana customers was subject to the low rate set out under IC 6-2.1-2-4. The statute provides that, "The receipt of gross income from the following is subject to the [low] rate of tax prescribed in section 3(a) of this chapter: (1) wholesale sales . . . (4) selling at retail."

Under IC 6-2.1-2-2, IC 6-2.1-2-3, IC 6-2.1-2-4 the audit was correct in determining that money received from the sale of goods – temporarily stored an Indiana customer's location – to that particular customer was subject to Indiana gross income tax at the low rate.

Other than disagreeing with this adjustment, taxpayer has provided no substantive basis upon which the Department is justified in reconsidering the audit's original determination.

FINDING

Taxpayer's protest is respectfully denied.

III. Business / Non-business Classification – Adjusted Gross Income Tax.

In reviewing taxpayer's adjusted gross income tax returns, the audit reclassified certain of taxpayer's income. The audit concluded that taxpayer incorrectly classified interest income, income derived from renting unused corporate property, and royalty income as "non-business income." The audit reclassified all three of these income categories as "business income."

In addition, the audit made an adjustment to reflect taxpayer's correct federal taxable income in order to properly represent a sale of stock which was treated as a sale of assets under I.R.C. § 338(h)(10). The audit concluded that the money received from the sale of stock should be treated as "business income." Again, taxpayer disagrees concluding that the money should be treated as "non-business income."

For purposes of determining a taxpayer's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three factor formula. IC 6-3-2-2(b). In contrast, non-business income is allocated to Indiana or it is allocated to another state. IC 6-3-2-2(g) to (k). Therefore, "whether income is deemed business income or non-business income determines whether it is allocated to a specific state or whether it is apportioned between Indiana and other states [in which] the taxpayer is conducting its trade or business." May Department Store Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651, 656 (Ind. Tax Ct. 2001).

Taxpayer's argument, that all four of these income categories are "non-business income," is significant because if taxpayer is correct, all this income is allocated elsewhere and is not relevant in calculating taxpayer's Indiana adjusted gross income tax.

The benchmark for determining whether income can be apportioned is the distinction between "business income" and "non-business income." That distinction is defined by the Indiana Code as follows:

The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operation. IC 6-3-1-20.

"Non-business income," in turn, "means all income other than business income." IC 6-3-1-21. For purposes of calculating an Indiana corporation's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three-factor formula, while non-business income is allocated to Indiana or another state in which the taxpayer is doing business. May, 749 N.E.2d at 656. In that decision, the Tax Court determined that IC 6-3-1-20 incorporates two tests for determining whether the income is business or non-business: a transactional test and a functional test. Id. at 662-63. Under the transactional test, gains are classified as business income when they are derived from a transaction in which the taxpayer regularly engages. The particular transaction from which the income derives is measured against the frequency and regularity of similar transactions and practices of the taxpayer's business. Id. at 658-59.

Under the functional test, the gain arising from the sale of an asset will be classified as business income if the acquisition, management, and disposition of the property generating income constitutes an integral part of the taxpayer's regular trade or business operations. *See* IC 6-3-1-20.

Department regulations 45 IAC 3.1-1-29 and 45 IAC 3.1-1-30 provide guidance in determining whether income is business or non-business under the transactional test. 45 IAC 3.1-1-29 states in relevant part that, "Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is 'business income' or 'non-business income' is the identification of the transactions and activity which are the elements of a particular trade or business." 45 IAC 3.1-1-30 provides that, "[f]or purposes of determining whether income is derived from an activity which is in the regular course of the taxpayer's trade or business, the expression 'trade or business' is not limited to the taxpayer's corporate charter purpose of its principal business activity. A taxpayer may be in more than one trade or business, and derive business therefrom depending upon but not limited to some or all of the following:

- (1) The nature of the taxpayer's trade or business.

- (2) The substantiality of the income derived from the activities and the percentage that income is of the taxpayer's total income for a given tax period.
- (3) The frequency, number of continuity of the activities and transactions involved.
- (4) The length of time the property producing income was owned by the taxpayer.
- (5) The taxpayer's purpose in acquiring and holding the property producing income.

The functional test focuses on the property being disposed of by the taxpayer. Id. Specifically, the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. May, 749 N.E.2d at 664. In order to satisfy the functional test, the property generating income must have been acquired, managed, and disposed of by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. In May, the Tax Court defined "integral" as "part of or [a] constituent component necessary or integral to complete the whole." Id. at 664-65. The court concluded that petitioner retailer's sale of one of its retailing divisions was not "necessary or essential" to the petitioner's regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not the petitioner. Id. at 665. In effect, the court determined that because the petitioner was forced to sell the division in order to reduce its competitive advantage, the sale was not integral to the petitioner's own business operations. Id. Therefore, the proceeds from the division's sale were not business income under the functional test. Id.

A. Interest, Rent, Royalty Income.

Taxpayer receives money from the investment of "excess corporate cash" in short term deposit accounts. Taxpayer receives money from "the rental of unused corporate property." Taxpayer receives money in the form of "copyright[] and patent[]" license royalties.

Under the "transactional" test, these three categories of income are properly classified as business income because this income is derived from activities in which taxpayer regularly engages. There is nothing especially extraordinary about a company investing its excess cash in short-term, interest-bearing accounts; to the contrary, it would be decidedly irregular for any business entity – having access to unused cash assets – to allow those assets to remain dormant and unexploited. Similarly, taxpayer's practice of renting underutilized corporate property and licensing its copyrights and patents are also activities which occur in the regular course and operation of the taxpayer's business. Taxpayer argues that it is in the business of "producing and selling high performance specialty chemicals" and that it is not in the business of investing cash, renting property, or licensing intellectual property. However, the issue is not whether this income is or is not high-performance chemical income; the issue is whether or not receipts in the form of interest, rental, and royalties are *business* income. Under the "transactional test," this income is.

These first three income categories are also properly classified as business income under the functional test. The property to which this income is attributable – excess cash, underutilized property, and intellectual property – were all acquired and managed by the taxpayer "in a process integral to taxpayer's regular trade or business operations." May, 749 N.E.2d at 664. Taxpayer

did not stumble across these assets by sheer happenstance. The cash, rental property, and intellectual property are each essential components within taxpayer's diverse but integrated business operation.

B. Deemed Sale of Assets.

Taxpayer and parent company entered into an agreement, pursuant to I.R.C. § 338(h)(10), whereby taxpayer sold its stock in the form of a "deemed asset sale." Under I.R.C. § 338(h)(10), the taxpayer was deemed to have sold all of its assets to the "new target" on the date of acquisition and immediately distribute the proceeds from this deemed asset sale to its parent corporation in complete liquidation.

Taxpayer is in the business of selling "high performance chemicals," providing "chemical management services," and in managing the assets related to those particular business activities. The deemed sale of assets was an extraordinary and nonrecurring transaction for the taxpayer. Therefore, the deemed sale does not meet the transactional test because it was not activity which occurred "in the regular course of the taxpayer's trade or business." 45 IAC 3.1-1-30.

Taxpayer chose to enter into a "deemed sale" of its assets thereby generating a substantial gain. Taxpayer's independent decision to dispose of its assets was a decision necessarily integral to the taxpayer's property and meets the requirements set out under the functional test. Accordingly, the proceeds resulting from the sale of its assets were appropriately classified as business income.

FINDING

Taxpayer's protest is respectfully denied.